CENTRAL BANKS.

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It is obviously impossible, within the limits of time at my disposal, to discuss in a comprehensive fashion the many problems suggested by the proposal to establish a central bank in the United States. I shall, therefore, attempt to do no more than merely indicate certain conditions which are likely to render the task of a central bank in this country extremely unlike that of the central banks of Europe—so unlike, indeed, that European experience affords little aid in estimating the probable results, which we might attain through its operation. In the second place I shall suggest certain less revolutionary remedies for our financial ills.

The problem which would present itself to the central bank in its capacity as government fiscal agent would be both difficult and unique. In England, France, and Germany government balances are comparatively small. The normal balance is less than $50,000,000, and, at least in recent years, the maximum has not reached $100,000,000. Moreover, the fluctuations of any single year are typical of every year, and being, therefore, foreseen, can be taken into account in the money market generally as well as by the central bank. In the United States, owing to our haphazard methods of legislation regarding appropriations, there is no uniformity in the fluctuations of government funds. During the first of the last four years the surplus was very nearly stationary; then came nearly two years of growth, adding nearly $150,000,000, followed by more than a year of as pronounced decline.

During all that time the surplus has been greater than the maximum balances of England, France, and Germany taken together, and, during many months, greater than the total deposit liabilities of the Bank of England.

Our government surplus is, then, peculiar in that it is a large and, to a considerable extent, a permanent fund. The people would certainly and properly insist that it be used with some reasonably close approximation to the population of different sections of the country. But for the central bank to lend everywhere directly to the business community would be an evident impossibility. Thousands of branches would be required to furnish the facilities afforded by the Bank of France or of Germany through their network of something like five hundred branches. To lend chiefly through a few branches like the Bank of England, would not secure the same results in this country. In England, and indeed in all countries which have central banks, there is a high degree of concentration throughout the banking system. Somewhat less than a hundred banks in England occupy the banking field with several thousand branches. Credit, therefore, is highly fluid. If the Bank of England increases its loans in London, the other banks are then in better position to meet further requirements, whether in London or at their provincial branches. In the United States branch banking is generally prohibited. Each bank engages in local business alone, if exception be made of the employment of temporarily idle funds by outside banks in the large cities. Loans made by a central bank in New York or Chicago would have no influence whatever upon the available lending resources in Massachusetts or in Iowa. The central bank would, therefore, be obliged to lend to the banks generally. In other words, it would have to decide between the competing requests of fifteen

thousand or more banks throughout the country. While conceding that this would not be an impossible task for a central bank, it is at the same time evident that the undertaking is quite unlike anything performed by existing central banks in Europe. The prediction may be ventured that the government funds would be distributed in some more or less permanent fashion not altogether unlike that with which we are now familiar. To be sure, we should escape the inconvenience which arises from the hoarding of large sums in the Treasury, but that end could be readily gained if the Secretary of the Treasury were instructed to deposit in the national banks everything above a certain working balance.

Very much the same difficulties present themselves with regard to the issue of an elastic currency by a central bank. The issue of notes would be made through loans, and the central bank once more would be obliged to decide between the requests of thousands of banks. Moreover, the issue of notes would remove one very valuable restraint upon the expansion of credit in this country. Where checks are in general use, credit in the form of deposits has remarkable expansive qualities. Seasonal demands, if not too large, simply remind the banker that his deposit obligations are for payment on demand. Our crop-moving requirements call for perhaps $50,000,000, an amount which our deposit banks should be able to pay out without disturbance. Inability to do so calls for a more conservative policy during the summer months rather than an additional extension of credit in the autumn. It should also be recognized that the results secured through the issue of notes by central banks in the countries of continental Europe do not afford much indication of what might be expected in this country. Where the check habit is not generally developed the extension of banking

credit is pretty closely limited to the money secured by the banks from capital surplus and the money paid in by depositors, together with the notes issued by the banks. In this country banks are able to lend their credit more largely through the granting of deposit credits upon their books. A given addition to their cash holdings permits an extension of credit to several times that amount. By substituting the notes issued by a central bank for money now in circulation which could be counted as reserve, our banks could further enlarge the credit structure until checked by gold exports, unsound business conditions, and lack of confidence. The Bank of England is the only central bank in a country in which deposit banking is highly developed, but it affords no example of the effects of the issue of credit bank notes, since its notes are practically gold certificates. It may also be added that the Bank of England has managed very well without the power of extending credit in the form of notes.

The better disposition of government funds, and the issue of notes in normal times, are, however, of but insignificant importance in comparison with the service which a central bank is expected to render in times of crisis by those who urge its adoption. Any device would indeed be welcome which would mitigate the recurrent panics and suspensions to which the American credit system has been conspicuously subject. It is necessary, however, to make certain that the causes of these troubles are of a nature to be removed by a central bank, and if so, whether more simple remedies are not equally promising.

During a crisis it is important that loans be continued, that gold exports be checked, and, if possible, gold imports be secured, and, above all, that the banks continue cash payments, so that the domestic exchanges may not be dislocated. The first of these objects—the continuance

of loans—has been secured since the crisis of 1857 through the device of the clearing house loan certificate. Unfortunately, however, the issue of these certificates has come to be regarded as somehow involving the suspension of cash payments. This view is based upon an entirely mistaken conception of the purpose and origin of the loan certificate. In the crisis of 1857, the New York banks generally curtailed their loans, because each bank feared an unfavorable clearing balance. The loan certificate was first made use of in 1860 purely for payments between banks. It removed the temptation to pursue a policy of loan contraction because a favorable balance could be paid in certificates and not in money. The use of this device does not diminish in the slightest the obligation of the bank to pay its depositors cash on demand. It is indeed true that in some of the western southern cities the loan certificate has been used in payment to depositors. Such use is demoralizing and cannot be too strongly condemned. Still another advantage may be mentioned from the issue of loan certificates when confined to payments between banks. It is a ready means of rendering aid to the weaker banks, the necessity of which in a crisis was well illustrated in the case of certain trust companies in New York in 1907. It is of course possible that a central bank would be able to handle a crisis, so far as loans are concerned, more satisfactorily, but it is at least uncertain. At all events, we have in the loan certificate an alternative method which has proved adequate in the past.

Continuing our examination of past experience in the matter of loans, it is significant that loans have not been greatly diminished on account of crises. The national bank returns for August and December, 1907, for example, show a reduction for the country as a whole of

but slightly more than two per cent, and a positive increase in most of the cities. Money rates, especially for call loans, in that and other crises, did indeed reach much higher levels than in other countries during similar disturbances. In part this is due to the system, peculiar to ourselves, of daily settlements on the Stock Exchange. In part it is due to a failure to recognize that no class of loans, not even call loans, can be reduced suddenly upon a wholesale scale by the banks generally. Money pools are a momentary device, and the clearing house loan certificate is a more permanent device which check the unavailing effort to reduce the customary banking accommodation.

Summing up the situation with regard to loans, we find difficulties which are not incapable of modification under our present system. The same difficulties would present themselves if we had a central bank, especially those arising from our Stock Exchange methods, from the number of banks which would require support and the much larger number the coöperation of which it would be necessary to secure.

Little need be said with reference to foreign exchange, although to secure favorable exchanges is the chief concern of foreign central banks. We have never experienced any difficulty in securing gold imports, with the possible exception of the crisis of 1893, when our currency was redundant. The character of our foreign trade places us in a position of great advantage. Moreover, our exporters regularly draw bills upon foreign purchasers, and these bills are regularly discounted in Europe. Consequently, payments for our exports are immediately convertible into cash. If any difficulty were to arise from this source, it would be due to the large amount of anticipatory and finance bills which are drawn

by foreign exchange houses upon their European correspondents. Had the volume of such bills been as large, as has at times been the case, just before the crisis in 1907, we might not have been able to draw any large amount of money from Europe. This is a danger which could hardly be prevented if we had a central bank. Moreover, it should be noted that some of the advocates of a central bank seem to expect that by its means still greater recourse may be had to European loanable funds, through the discount abroad of purely domestic bills. When it is remembered that we finance practically none of our over-sea trade, and incur much temporary indebtedness by finance bills, a plan which would still further expand our temporary foreign obligations seems hardly conservative, to say the least.

Finally we come to the most serious weakness which has manifested itself in the working of our banking system—the alomst invariable suspension of cash payments whenever a crises occurs. If a central bank is the only means of preventing this calamitous evil, that alone is indeed sufficient reason for its establishment. It does not, however, seem clear that cash payments cannot be maintained without a central bank. Where there is a central bank this responsibility rests primarily upon it. In this country the responsibility is divided among all the banks, but it is not equally divided. National banks in reserve and in central reserve cities, which secure bankers' deposits, are in this respect analogous to the central banks of Europe. There are less than four hundred national banks in those cities, and by no means all of them secure such deposits. Concentrating attention on the central reserve cities, it is significant that in November, 1908, $700,000,000 out of a total of about $1,000,000,000 of bankers' deposits were held in New York. Nor is this all.

Very nearly all of these deposits were held by the six largest New York banks, and these banks held quite four-fifths of the total cash held by the New York national banks. These banks in accepting these enormous bankers' deposits have clearly incurred responsibilities similar to those of European central banks. But it is equally true that this responsibility is not so clearly recognized as it is in Europe. Indeed, it may be doubted whether it is perceived at all.

Now the question arises in what way a central bank would be at an advantage over this small number of banks in meeting crisis conditions, except in the one respect of the power to issue notes, and that, it may be observed once more, is not a power of practical utility in the case of the Bank of England unless the act of 1844 is suspended.

The national banks compete for bankers' deposits, offering interest and other inducements, while it is a universal rule among central banks to pay nothing for deposits. This makes it possible for the latter to hold large reserves and still earn reasonable profits. For many years after the practice was inaugurated in New York the policy was severely criticised, but long custom has led to its general acceptance. Nothing short of a law against interest payments upon bankers' deposits will be likely to remove this particular evil.

The fundamental difficulty in our present system, however, is due, not to insufficient cash reserves, but to the failure to use them in emergencies. Partly by law and even more by custom we have burdened ourselves with reserve restrictions which are unique in banking practice. To maintain a certain proportion between cash and deposit liabilities has become an object to which every other consideration has become secondary. It is, indeed, true

that a reserve requirement is desirable for normal times in a system which has thousands of banks. But it is equally important that the propriety of using reserves in emergencies should be recognized both in legislation and by public opinion. If one of the existing central banks were subjected to a restriction of this nature, suspension could not be avoided. Almost equal danger would be incurred in this country were the central bank unfettered in the use of its reserve, while the present restrictions remained in force as regards the other banks. The same scramble for funds that has characterized previous crises would unquestionably arise.

It may, however, be suggested that a central bank would be able to meet the situation by indefinitely large issues of notes. This is perhaps possible. But in that case the demand for a central bank becomes merely a demand for a device to secure elastic notes in order to retain a rigid reserve. It is submitted that elasticity in reserves is a far more natural and simple remedy. It might, however, be of advantage to provide an emergency circulation which would be taken out by any bank, under conditions which would not be so complicated as to render its use unlikely.

That our present reserve requirements are the chief cause of the suspension of cash payments is clearly shown by the course of events during the crisis of 1907. During the last two weeks of October, while the disturbance was almost entirely confined to New York City, the clearing house banks experienced a net loss of about $40,000,000, and their reserves were $53,000,000 below the twenty-five per cent requirement. Gold imports had been engaged, the Treasury was depositing surplus funds, and arrangements were being made to increase the note circulation. More money therefore was in sight. Demands

for money were being made in increasing magnitude by bankers in all parts of the country upon their New York correspondents. Thereupon cash payments were restricted. The New York banks at the time held $224,000,000, and in the following three weeks allowed the reserve to fall off only $9,000,000. Thereafter to the end of the year, while the currency premium continued, reserves were increased until they reached $251,000,000.

The contention of bankers that suspension was unavoidable rested entirely upon the delusion that the reserve percentage is to be maintained though the heavens fall. Contrast with the action taken by the Bank of England is significant and at the same time humiliating. At the beginning of the crisis it had a banking reserve of $125,000,000. In two weeks, chiefly on account of gold exports to the United States, it lost some $40,000,000. The Bank of England then held only $85,000,000, while the New York banks held over $200,000,000, and yet no one in London even thought of the possibility that the Bank might suspend. The Bank had no more means of attracting funds than were possessed by the New York banks. In fact, it did not in the closing weeks of the year attract so much gold from other countries as was brought to New York. In London there was general confidence that the Bank of England would continue to meet its obligations. In this country, on account of experiences in former crises, that confidencce was lacking. If, however, the six large New York national banks had announced at the end of October their united determination to meet all demands of their outside banking depositors, it cannot be doubted that confidence would have been strengthened and unnecessary demands would soon have diminished. Had this not proved to be the case, and had the payment of a hundred millions or more

proved unavailing, then suspension might have been resorted to as a means of security. The attempt, even if a failure, would not have involved disastrous consequences, since, when the banks suspend it matters little whether they hold a little more or a little less reserve. In any case, the reserve ceases to be available for use.

Progress in this direction, however, does not seem very likely. The fetich of a fixed reserve has apparently taken a stronger hold upon the community since the recent crisis. Trust companies and state banks are being brought under its sway. Unless there is a parallel development of right thinking about the uses and purposes of reserves, it may be confidently predicted that this legislation will tend to hasten rather than prevent suspension. Something might be accomplished if the proportion of reserve which may be deposited in city banks were diminished. An emergency currency would be of some assistance. But above all we must recognize that a reserve is to be used, not hoarded and increased, in time of crisis.